ALLIANCE FOR american manufacturing

April 15, 2015

Honorable John Thune
Co-Chair
Business Income Tax Working Group
Committee on Finance
United States Senate
Washington, DC 20510

Honorable Ben Cardin
Co-Chair
Business Income Tax Working Group
Committee on Finance
United States Senate
Washington, DC 20510

Dear Senator Thune and Senator Cardin:

On behalf of the Alliance for American Manufacturing (AAM), I want to thank you and your colleagues on the working group for your efforts to improve the business tax system. AAM is a unique partnership between the United Steelworkers Union and some of America's leading manufacturers. Our mission is to help foster an environment that strengthens manufacturing in the United States, thereby creating high-paying private-sector jobs and economic growth. We are grateful for the opportunity to submit comments, as we believe the impact of tax reform on domestic manufacturing, innovation, and job creation is critical to America's economic security.

Congress has continually recognized that a healthy manufacturing sector helps grow our overall economy. Every $1 spent on domestically produced manufactured goods generates $1.35 in economic activity, far outpacing every other major sector. Manufacturing is also an engine of innovation, generating more patents, R&D expenditures, and employing more engineers and scientists than any other sector.

These economic benefits accrue when manufacturing processes occur in the United States. Consequently, the tax code has long had provisions like accelerated depreciation, expensing of research and development (R&D) costs, percentage depletion, and the domestic production deduction (which replaced similar incentives), all of which were designed to encourage capital investment, innovation, and domestic manufacturing production. These provisions are broad-based incentives thoughtfully and deliberately enacted by Congress to encourage economic and job growth in the United States.

Chairman Hatch recently said, "Economic growth comes from growth in employment of labor, of physical and intangible capital, and from technological change…Reductions in marginal effective tax rates on labor and capital can and do have positive macroeconomic effects that cannot and should not be ignored, by tax policymakers or by Congressional scorekeepers."

We agree. Effective tax rates that account for investment incentives are more important than statutory rates in determining whether a business invests and where a company decides to locate its operations.

Thus, tax reform could do more harm than good if it is guided merely by the drive to lower statutory tax rates and broaden the base. A number of specific provisions in the current tax code (described below) bear special scrutiny in light of the incentives they provide to domestic manufacturers — the withdrawal of which could diminish overall capital investment and U.S. competitiveness.

As a matter of simple math, repealing these incentives to finance a general rate reduction—in the context of a revenue-neutral reform of business taxes—will raise the marginal effective tax rate and result in a net tax increase on the domestic manufacturing sector. This is confirmed by a 2011 Ernst & Young study, which found that a revenue-neutral corporate tax rate reduction financed by "eliminating all business tax expenditures would disproportionately hit the manufacturing industry." That net tax increase could not only threaten the slow recovery of domestic manufacturing from the recent recession, it would also hinder the long-term efforts to rebuild and grow our domestic manufacturing base.

The tax reform discussion should be about whether alternative policies could create more investment and economic growth than current policies. Only if the alternative policies have clear, distinct, and long-lasting advantages should the current incentives be repealed and replaced. We welcome the opportunity to be part of that discussion and help Congress improve our tax system in a manner that best ensures our nation's economic future.

Specific Proposals Affecting Domestic Production

We take a broad view of the impact of tax reform on manufacturing, considering both the direct impact on manufacturers and the treatment of suppliers and customers like extractive industries and agriculture. We believe that significant changes in the tax treatment of these industries warrant greater analysis as they could have adverse impacts on investment and growth.

Our remaining comments focus on recent proposals to slow cost recovery for capital investments (reducing or eliminating accelerated depreciation) and research and development (requiring amortization rather than expense treatment under section 174), and proposals to eliminate the domestic manufacturing deduction under section 199.

The current cost recovery rules for physical capital and R&D rules help reduce the effective tax rates for new investments in U.S. manufacturing and research operations. These rules will only become more important if interest rates rise, as most expect. By contrast, a reduction in statutory tax rates financed by slowing down cost recovery for R&D and capital investment would benefit past investments and result in higher effective tax rates on future investments. The U.S. would become a less desirable location for future research and capital investments than under current law.

This is confirmed by the Joint Tax Committee's analysis of Chairman Camp's tax reform proposal:

> The reduction in statutory tax rates on corporate and non-corporate business income increases the after-tax return to investment for some businesses that do not make use of many of the business deductions under present law. For those businesses that do make use of accelerated depreciation, expensing of research and experimentation expenses, or other business tax expenditures, the elimination of these provisions is expected to reduce the after-tax return on investment. Overall, the proposal is expected to increase the cost of capital for

domestic firms, thus reducing the incentive for investment in domestic capital stock. (See *Macroeconomic Analysis of the "Tax Reform Act of 2014," JCX 22-14, p. 15)*.

With the strong established link between the location of manufacturing activities and research and development, we believe the rules for physical investment and R&D are equally important. In fact, economic studies have found that knowledge spillovers from research and industrial activity remain mostly in the country in which they occur. Since manufacturing firms are responsible for the bulk of innovative research in the United States, changes to the tax code that cause an erosion of our manufacturing base will result in a shift of research activities overseas. Similarly, reducing U.S. research activities will limit innovation, manufacturing growth, and threaten our future economic competitiveness. Thus, we believe that slowing cost recovery of capital investment and R&D expenses in exchange for a revenue-neutral corporate tax rate reduction would be harmful, especially when there is broad agreement among economists and policymakers that the United States needs to invest more in research and manufacturing to spur innovation, production, and job creation.

Also, as several commentators have noted, changes in cost recovery are a timing difference, while lowering corporate rates is a permanent difference. Thus, a recent report prepared by former Joint Tax Committee economists prepared for the CRANE Coalition found, "Offsetting the cost of tax reform with a temporary timing change of receipts is imprudent tax policy. Because of the front-loaded nature of the depreciation allowance, a tax reform measure that relies on cuts in accelerated depreciation as a long-term revenue offset would have the effect of increasing future budget deficits. Those deficits would force the government to consider budgetary changes in the future – including the possible restoration of higher tax rates." (*Long-Run Revenue Effects of Changes in Cost Recovery Allowances,* Quantria Strategies, March 2015).

For similar reasons, under these types of proposals, only taxpayers with growing expenditures for capital investment or R&D would face permanent tax increases. For example, under Chairman Camp's discussion draft that requires capitalization and amortization of R&D expenses over 5 years, companies with flat R&D expenditures would receive essentially the same annual deduction as under current law after 5 years. Thus, only those companies that are increasing their R&D (and capital) expenditures, something that could have positive benefits for the overall economy, would continue to face tax increases. That would be an unfortunate result.

It is also important to note, with respect to expensing of R&D costs, that Congress recognized the administrative difficulty of distinguishing between R&D expenses and ordinary and necessary business expenses deductible under section 162. Recently, the IRS has struggled to promulgate detailed regulations attempting to distinguish between deductible repairs to property that can be expensed and improvements that must be capitalized. Requiring capitalization of R&D expenses would likely require the IRS to start another similar, complex regulation project to distinguish between R&D expenses and deductible business expenses.

Some of our members also participate in mining operations in the United States, producing key inputs to U.S. manufacturing operations. The percentage depletion deduction encourages mining in the United States, allowing producers to deduct a percentage of gross or net income from the extraction of natural resources. This incentive reduces the uncertainty in mining

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investments and lowers the cost of capital for miners and for their customers. Maintaining this incentive in tax reform will help U.S. firms compete against imports.

We also are concerned with the potential repeal of the section 199 domestic manufacturing deduction in order to provide a general rate reduction. Again, it is clear this will result in a significant tax increase on U.S. manufacturing, which will impede the recovery and growth of this sector. Section 199 was enacted in 2004 as a replacement for the FSC-ETI regime, which had been ruled an "export subsidy" by the WTO. As the Finance Committee recognized at the time, an appropriate replacement was necessary to continue to promote recovery and growth in the manufacturing sector "to foster job creation." Thus, we hope that Congress, as it did in 2004, will recognize the important spillover benefits of the U.S. manufacturing sector that are critical to economic growth and job creation and adopt tax reform policies that strengthen this important industry.

In closing, we believe that any effort to reform the tax code must be viewed as a long-term effort to improve domestic production, job creation, and economic security. If Congress is to adopt major changes in the tax code, it must spend considerable time addressing the transition from current law to a new system with the goal of maximizing economic growth and opportunity. Companies that have relied on current law must not be penalized during such a transition.

Thank you for the opportunity to share our views with you as you work to overhaul the U.S. corporate tax code. We encourage you to keep the goals of economic growth, job creation, and prosperity at the forefront of your work. We look forward to working with you on these important issues.

Sincerely,

Scott N. Paul
President

Cc: Chairman Orrin Hatch
Ranking Member Ron Wyden
Members of the Senate Finance Committee